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Communication of internal control related matters noted in an audit; Statement on auditing standards, 060

American Institute of Certified Public Accountants. Auditing Standards Board

Statement on Auditing Standards

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AICPA American Institute of Certified Public Accountants

Communication of Internal Control Structure Related Matters Noted in an Audit

1. This Statement provides guidance in identifying and reporting conditions that relate to an entity's internal control structure observed during an audit of financial statements. It is contemplated that the communication would generally be to the audit committee or to individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one, such as the board of directors, the board of trustees, an owner in an owner-managed enterprise, or others who may have engaged the auditor. For the purpose of this Statement, the term *audit committee* is used to refer to the appropriate recipient of the communication. This Statement also provides guidance on establishing, between the auditor and client, agreed-upon criteria for identifying and reporting additional matters beyond those required by this Statement.

Reportable Conditions

2. During the course of an audit, the auditor may become aware of matters relating to the internal control structure that may be of interest

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to the audit committee. The matters that this Statement requires for reporting to the audit committee are referred to as *reportable conditions.*[1] Specifically, these are matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.[2] Such deficiencies may involve aspects of the internal control structure elements of (*a*) the control environment, (*b*) the accounting system, or (*c*) control procedures. (See the Appendix for examples of reportable conditions.)

3. The auditor may also identify matters that, in his judgment, are not reportable conditions as defined in paragraph 2; however, the auditor may choose to communicate such matters for the benefit of management (and other recipients, as appropriate).

Identifying Reportable Conditions

4. The auditor's objective in an audit of financial statements is to form an opinion on the entity's financial statements taken as a whole. The auditor is not obligated to search for reportable conditions. However, the auditor may become aware of possible reportable conditions through consideration of the elements of the internal control structure,[3] application of audit procedures to balances and transactions, or otherwise during the course of the audit. The auditor's awareness of reportable conditions varies with each audit and is influenced by the

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[1]This Statement supersedes SAS No. 20, *Required Communication of Material Weaknesses in Internal Accounting Control*, and paragraphs 47 through 53 of SAS No. 30, *Reporting on Internal Accounting Control*, and related auditing interpretations. This Statement does not affect the reporting of material weaknesses noted in an engagement to report on an entity's internal control structure.

[2]The auditor should also consider matters coming to his attention that relate to interim financial reporting outside the entity in the communication contemplated by this Statement.

[3]The *internal control structure* refers to the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved. (See Statement on Auditing Standards No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, for additional key definitions.)

nature and extent of audit procedures and numerous other factors, such as an entity's size, its complexity, and the nature and diversity of its business activities.

5. In making the judgment as to which matters are reportable conditions, the auditor should take into consideration various factors relating to the entity, such as its size, complexity and diversity of activities, organizational structure, and ownership characteristics.

6. The existence of reportable conditions related to internal control structure design or operation may already be known and, in fact, may represent a conscious decision by management — a decision of which the audit committee is aware — to accept that degree of risk because of cost or other considerations. It is the responsibility of management to make the decisions concerning costs to be incurred and related benefits. Provided the audit committee has acknowledged its understanding and consideration of such deficiencies and the associated risks, the auditor may decide the matter does not need to be reported. Periodically, the auditor should consider whether, because of changes in management, the audit committee, or simply because of the passage of time, it is appropriate and timely to report such matters.

Agreed-Upon Criteria

7. The auditor and client may discuss the internal control structure and concerns regarding its functioning when making arrangements for the audit. Clients may request the auditor to be alert to matters and to report conditions that go beyond those contemplated by this Statement. The auditor is not precluded from reporting matters that he views to be of value to management in the absence of any specific request to do so.

8. Agreed-upon arrangements between the auditor and the client to report conditions noted may include, for example, the reporting of matters of less significance than provided for by this Statement, the existence of conditions specified by the client, or the results of further investigation of matters noted to identify underlying causes. Under these arrangements, it is possible that the auditor may be requested to visit specific locations, assess specific control procedures, or undertake specific procedures not otherwise planned.

Reporting — Form and Content

9. Conditions noted by the auditor that are considered reportable under this Statement or that are the result of agreement with the client should be reported, preferably in writing. If information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the working papers.

10. The report should state that the communication is intended solely for the information and the use of the audit committee, management, and others within the organization. When there are requirements established by governmental authorities to furnish such reports, specific reference to such regulatory authorities may be made.

11. Any report issued on reportable conditions should —

- Indicate that the purpose of the audit was to report on the financial statements and not to provide assurance on the internal control structure.
- Include the definition of reportable conditions.
- Include the restriction on distribution as discussed in paragraph 10.

12. The following is an illustration of the sections of a report encompassing the above requirements.

> In planning and performing our audit of the financial statements of the ABC Corporation for the year ended December 31, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.
>
> [*Include paragraphs to describe the reportable conditions noted.*]
>
> This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the organization (or specified regulatory agency or other specified third party).

13. In some circumstances, the auditor may wish to include additional statements in the report regarding the inherent limitations of the internal control structure in general, the specific extent and nature of his consideration of the internal control structure during the audit, or other matters regarding the basis for the comments made.

14. In a communication that contains both observations deemed by the auditor to be reportable conditions, as defined, and other comments, it may be appropriate to indicate which comments are in each category.

15. A reportable condition may be of such magnitude as to be considered a material weakness. A *material weakness* in the internal control structure is a reportable condition in which the design or operation of the specific internal control structure elements do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Although this Statement does not require that the auditor separately identify and communicate material weaknesses, the auditor may choose or the client may request the auditor to separately identify and communicate as material weaknesses those reportable conditions that, in the auditor's judgment, are considered to be material weaknesses.

16. The following is an illustration of the sections of a report that may be used when the auditor wishes, or has been requested, to advise the audit committee in writing that one or more reportable conditions have been identified, but none is deemed to be a material weakness.

> [*Include the first paragraph in the report illustrated in paragraph 12.*]
>
> [*Include paragraphs to describe the reportable conditions noted.*]
>
> A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.
>
> Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose

all reportable conditions that are also considered to be material weaknesses as defined above. However, none of the reportable conditions described above is believed to be a material weakness.

[*Include the final paragraph in the report illustrated in paragraph 12.*]

17. Because of the potential for misinterpretation of the limited degree of assurance associated with the auditor issuing a written report representing that no reportable conditions were noted during an audit, the auditor should not issue such representations.

18. Because timely communication may be important, the auditor may choose to communicate significant matters during the course of the audit rather than after the audit is concluded. The decision on whether an interim communication should be issued would be influenced by the relative significance of the matters noted and the urgency of corrective follow-up action.

19. The provisions in this Statement should not be viewed as precluding an auditor from communicating to a client a variety of observations and suggestions regarding its activities that go beyond internal control structure related matters. Such matters may deal with operational or administrative efficiencies, business strategies, and other items of perceived benefit to the client.

Effective Date

20. This Statement is effective for audits of financial statements for periods beginning on or after January 1, 1989, with early application permissible.

Appendix

Examples of Possible Reportable Conditions

1. As indicated in paragraph 2 of this Statement, reportable conditions involve matters coming to the auditor's attention that relate to significant deficiencies in the design or operation of the internal control structure that, in the auditor's judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

2. The following are examples of matters that may be reportable conditions. They are grouped by categories of conditions and within categories by specific examples of conditions. Certain of these matters may also require communications under the provisions of other statements on auditing standards.

Deficiencies in internal control structure design

- Inadequate overall internal control structure design
- Absence of appropriate segregation of duties consistent with appropriate control objectives
- Absence of appropriate reviews and approvals of transactions, accounting entries, or systems output
- Inadequate procedures for appropriately assessing and applying accounting principles
- Inadequate provisions for the safeguarding of assets
- Absence of other control techniques considered appropriate for the type and level of transaction activity
- Evidence that a system fails to provide complete and accurate output that is consistent with objectives and current needs because of design flaws

Failures in the operation of the internal control structure

- Evidence of failure of identified controls in preventing or detecting misstatements of accounting information
- Evidence that a system fails to provide complete and accurate output consistent with the entity's control objectives because of the misapplication of control procedures
- Evidence of failure to safeguard assets from loss, damage or misappropriation
- Evidence of intentional override of the internal control structure by those in authority to the detriment of the overall objectives of the system
- Evidence of failure to perform tasks that are part of the internal control structure, such as reconciliations not prepared or not timely prepared

- Evidence of willful wrongdoing by employees or management
- Evidence of manipulation, falsification, or alteration of accounting records or supporting documents
- Evidence of intentional misapplication of accounting principles
- Evidence of misrepresentation by client personnel to the auditor
- Evidence that employees or management lack the qualifications and training to fulfill their assigned functions

Others

- Absence of a sufficient level of control consciousness within the organization
- Failure to follow up and correct previously identified internal control structure deficiencies
- Evidence of significant or extensive undisclosed related party transactions
- Evidence of undue bias or lack of objectivity by those responsible for accounting decisions

The Statement entitled Communication of Internal Control Structure Related Matters Noted in an Audit *was adopted by the assenting votes of nineteen members of the board, of whom three, Messrs. Bintinger, Clancy, and Neebes, assented with qualification. Messrs. Temkin and Ten Eyck dissented.*

Messrs. Bintinger, Clancy, and Neebes qualify their assent to this Statement because it precludes the auditor from stating in a written communication that no reportable conditions were noted during an audit. They believe that this is inconsistent with the objective of promoting better communication between auditors and audit committees. Mr. Bintinger and Mr. Clancy also believe a framework exists within which an auditor could provide such a representation, and the report illustrated in paragraph 12 describes that framework.

Mr. Bintinger further believes that because a written communication of reportable conditions is required to state that such a communication is restricted solely to the use of the audit committee, management, or others within the entity, a statement that no reportable conditions were noted is not subject to misinterpretation and should not be precluded by the Statement. Mr. Bintinger and Mr. Neebes also believe that precluding a statement in a written communication that no reportable conditions were noted is inconsistent with permitting such a statement to be made in an oral communication and with permitting a statement in a written communication that no reportable conditions were a material weakness.

Mr. Bintinger also qualifies his assent because paragraphs 14 and 15 do not require the auditor to segregate comments among reportable conditions, material weaknesses, or other matters. Since the purpose of this Statement is to improve communications, he believes the Statement should require the report to categorize each comment that, in the auditor's judgment, meets the requirements of a category for reporting.

Mr. Temkin dissents because he believes the concept of *reportable conditions* is poorly defined and inherently vague. In his opinion, replacing the concept of *material weaknesses* with *reportable conditions* provides less useful guidance than present literature. Mr. Temkin also believes this Statement will lead to increased inconsistency in reporting and to second-guessing of the auditor's judgments about what matters are reportable conditions. He also believes that because reportable conditions must be communicated to the audit committee without selectivity, the audit committee may receive information that is not useful to them, and this may obscure important issues.

Mr. Ten Eyck dissents because he believes the guidance in Statement on Auditing Standards No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, with respect to understanding the internal control structure, assessing control risk, and determining whether an internal control structure policy or procedure has been placed in operation and whether it is operating effectively, will not be consistently interpreted and appropriately applied in practice. In his opinion, that guidance is necessary for effective implementation of this Statement. As a result, he believes practitioners may fail to follow the guidance in this Statement because they misunderstand or misinterpret Statement on Auditing Standards No. 55.

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